BUDGET POLICY TASK FORCE FINDINGS AND RECOMMENDATIONS

Presented to Governor Mark Sanford

Presented by the Budget Policy Task Force

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Executive Summary

The Board of Economic Advisors (BEA) should be maintained as it is currently organized. The requirements of the BEA statute should be satisfied rigorously.

The Department of Revenue and the Department of Commerce should provide complete and accurate monthly state revenue data to the BEA on a timely basis.

The BEA's February 15 fiscal year estimate should be a binding constraint on the appropriations process.

The Capital Reserve Fund and General Reserve Fund requirements should not be increased, provided constraints are imposed on the use of excess reserves that may occur in a given fiscal year.

Funds in reserve accounts other than the General Reserve and the Capital Reserve should not be used to fund a deficit.

An official entity, such as the Comptroller General, should be given the responsibility of certifying the annual budget at each stage of the appropriations process. This balanced budget certification should take into account revenues and expenditures, the gross balance issue, and the matching of recurring and nonrecurring revenues with similar expenditures.

The statutory requirement for a governor's budget should be reformed to permit and encourage the formatting of the Gubernatorial budget as a policy document. In place of a detailed budget used primarily for accounting purposes, the governor should provide the General Assembly and the public a statement of priorities, goals and objectives for the state.

Any excess revenues in a fiscal year after the replenishment of reserves could be appropriated by the General Assembly as supplements to agency budgets. These supplements should not be used for recurring expenditures.

The recently established Joint Committee on Taxation should be assigned the responsibility of investigating and preparing a report on the relationship of state general fund revenues to state economic activity.

The Governor should lead the effort to discuss relative merits of user fees to pay for state services.

Performance-based and zero-based budgeting should be implemented to focus attention on program awareness, accountability, and results. Key components of a successful implementation will have to include leadership and vision.

A binding constitutional spending limitation on state appropriations that provides a more stable and predictable funding stream for state government should be enacted.

The state should discontinue the practice of budgeting recurring costs with non-recurring funds.

A more formal process of capital planning and budgeting should be used to meet the needs of the State. A Capital Budgeting Authority should be created which would be the origination point for all state buildings and bond requests.

For now, South Carolina should continue the annual budget process rather than moving to a biennial budget cycle, but sometime in the future consider moving to a biennial budget process

A constitutional prohibition should be enacted so that the exercise of a gubernatorial budget veto does not cause appropriations to exceed projected revenues.

REVENUE FORECASTING

Objective:

The Task Force focused on the process of forecasting and monitoring state revenues, and responding to revenue shortfalls and surpluses. The Task Force directives involved addressing a series of specific issues during the group's deliberations. The issues are:

BEA and revenue forecasting
Should the system of revenue forecasting be changed? Should the BEA be more insulated from the political process? Is the timing of the BEA reports adequate?

Revenue shortfalls
Is the 2 percent Capital Reserve Fund large enough to address mid-year shortfalls? When mid-year reductions are ordered, should exemptions for priorities be in place? Exactly how will this be done? Should restricted and earmarked funds be used to supplement the needs of the state that are traditionally addressed with the General Fund?

Revenue and the economy
Is the relationship between the economy and revenues changing? If so, what should be done about it? Should a strategy of fee for governmental service become more prominent where applicable?

Background:

The Task Force considered the relative merits of the current BEA arrangement for forecasting, monitoring, and reporting revenues as compared to other approaches. The alternatives discussed include:

- Eliminating the BEA while the forecasting, monitoring, and reporting functions retained in the Budget and Control Board (BCB) and the BCB Executive Director assuming the duties of the BEA

- Contracting for forecasting services that would supplement or replace the internal forecast alternatives provided by BEA staff

- Maintaining the basic BEA operating model but emphasizing the necessity of following the requirements of the current BEA statute and making other adjustments in the revenue forecasting and appropriations process. The subcommittee selected the third option as the basis for its recommendation.

Recommendation (Administrative):

The BEA should be maintained as it is currently organized. The requirements of the BEA statute should be satisfied rigorously. The meeting requirements to be satisfied are:

- Quarterly BEA meetings for the purpose of reviewing revenues relative to the official estimate

- BEA meeting by November 10 for the purpose of giving the next fiscal year's estimate

- An official meeting prior to providing the February final review, no later than February 15, and announcement of the final fiscal year estimate.

We note that the statute requires BEA to "consult with outside economic experts with respect to national and South Carolina economic and business conditions" prior to making or adjusting any forecast. This requirement must be met systematically and must include formal presentations by forecasters who address the economies of the nation and the state. We emphasize that the requirement applies to decisions that relate to making and adjusting any forecast. We further recommend producing the BEA Monthly Revenue Letter and all monthly revenue reports and related analyses without interruption throughout the calendar year. Finally, we recommend that the BEA chairman speak for the BEA, not for himself or herself, when communicating BEA decisions.

The subcommittee also discussed ways to improve the reliability of revenue data provided to the BEA by other state agencies. It was noted that monthly data from the Department of Revenue are often incomplete. It was also noted that data on the exercise of job credit agreements made by the Department of Commerce is not available to the BEA.

Recommendation (Administrative):

The Department of Revenue should provide complete and accurate monthly data to the BEA on a timely basis for the purpose of reporting and monitoring state revenues. The Department of Commerce should provide the Department of Revenue and the BEA an accurate accounting of outstanding job credit data that could affect monthly and annual corporate income tax revenues. The Department of Commerce should produce an annual report informing South Carolina citizens of the total job credits that have been given to firms that are expanding state operations and an estimate of the potential effect on state corporate income tax revenues.

Finally, the subcommittee considered how the BEA is currently constrained by statute in modifying a revenue estimate. By statute, the BEA can be requested to revise an estimate by the Governor, the General Assembly, or any BEA member.

Recommendation (Statutory):

To stabilize the estimate and budget-building process, the BEA February 15 fiscal year estimate should be a binding constraint on the appropriations process. However, if the BEA estimate is raised, the appropriation revenue estimate may not be increased. Any upward revisions made by BEA after February 15 will be for information only, not for use in changing appropriations in the current fiscal year. Any surplus revenues generated in a fiscal year will be applied first to replenish reserves. Any remaining funds will be appropriated for nonrecurring expenditures in the next fiscal year, preferably through the supplemental budget process.

RESERVE FUNDS

Objective:

The objective is to determine whether the current system of reserve funds is adequate and whether constraints should be placed on the adjustment of revenue forecasts in the budget process.

Background:

The adequacy of the reserve funds and ways to limit the practice of appropriating nonrecurring money for recurring expenditures was considered and discussed. As long as this practice is feasible, no capital reserve fund will be large enough to cushion the deficits that can be generated. It was in this discussion that the recommendation emerged for making the BEA's February 15 estimate a binding constraint for appropriations. With this constraint in place, any surplus revenues that occur in a given fiscal year will be carried forward for appropriations in the next year. The discussion also focused on

- The use of priority-based budget requests by state agencies that would improve decision making when budgets have to be cut

- Requiring a balanced appropriations bill regarding recurring and nonrecurring revenues

- Eliminating the Governor's Budget as a way to reduce competition to increase spending

- Strengthening the analytical requirements associated with certifying the revenue effects of proposed provisions that increase or decrease the most recently provided BEA revenue estimate.

Recommendations (Administrative):

- The 2 percent Capital Reserve and 3 percent General Reserve requirements are adequate; they should not be increased, provided constraints are imposed on the use of excess reserves that may occur in a given fiscal year (*BEA discussion.*)

- Pre-established priorities for budget cuts would be helpful, but it will be extremely difficult for the General Assembly to develop an appropriations bill that contains priorities to apply in the event of budget cuts. Priority information should be obtained by requiring state agencies to provide statutory based budgets with priorities identified

- Funds in reserve accounts other than the General Reserve and the Capital Reserve should not be used to fund a deficit

- An official entity such as the Comptroller General should be responsible to certify the annual budget at each stage of the appropriations process. This balanced budget certification should take into account revenues and expenditures, the gross balance issue, and the matching of recurring and nonrecurring revenues with similar expenditures.

Along with the certification of balance, certification of the revenue effects of individual bills by the BEA should continue and made more rigorous. Fiscal notes that contain a rigorous analysis of expected revenue effects should couple the BEA certification.

Recommendation (Statutory):

The statutory requirement for a governor’s budget should be reformed to permit and encourage the formatting of the Gubernatorial budget as a policy document. In place of a detailed budget used primarily for accounting purposes, the governor should provide the General Assembly and the public a statement of priorities, goals and objectives for the state.

Related to revenue surpluses and supplemental budgets, there are times when state revenues exceed BEA estimates. It is during these periods that constraints on appropriations with respect to funding recurring programs with nonrecurring funds become critical. Our recommendation on making the BEA February 15 estimate binding carries with it the recommendation that surplus funds be carried forward to the next fiscal year, with priority given to replenishing all reserve balances. Surplus funds that remain after replenishing reserve accounts would then become a part of a supplemental budget that would fund one-time programs.

Recommendation (Statutory):

Any excess revenue that occurs in a given fiscal year after the replenishment of reserves could be appropriated by the General Assembly as supplements to agency budgets. These supplements will not be used for recurring expenditures.

RELATIONSHIP OF REVENUES AND THE ECONOMY

Objective:

The objective is to determine whether the relationship between state revenues and the state’s economy have changed - thus yielding less revenue per percent of economic growth and determine the relative merits of the expansion of user fees.

Background:

Two specific areas were addressed and discussed.

- The relationship between state revenues and state economic activity
- The relative merits of expanded use of user fees for government services.

Evidence suggests that the relationship between state economic performance and state revenue has been altered. Revenue growth is not as responsive to total personal income growth. The apparent change in this relationship could be associated with any number of changing relationships that range from the fact that state economic growth is being driven by services, as opposed to manufacturing, that untaxed internet sales are a growing part of retail sales, and that untaxed lottery ticket sales may be replacing taxed retail sales. Accurate revenue forecasting depends on the accuracy of assumptions regarding the association between the state economy and state revenue. To the extent possible in state programs not related to welfare, those who benefit from state services should pay directly for the services. For example, where costs are clearly identifiable, as in the operation of state parks and licensing programs, user fees can be charged for the services. In some cases, it would be advisable for part of the revenues generated to be allocated to the agency involved for improving agency services.

Recommendation (Administrative):

- The General Assembly's Joint Committee on Taxation should report on the relationship of state general fund revenues to state economic activity. The report should consider all tax sources but should focus on the major revenue sources, e.g., sales tax, personal income tax, and corporate income tax. The final report should be completed by the end of the current fiscal year

- The Governor should lead and generate debate and discussion of the relative merits of user fees to pay for state services. To start this discussion, the Governor should recommend specific examples of where user fees can be implemented, how user fees might be set, and how user fee revenues would be used.

BUDGET DECISION-MAKING AND TECHNIQUES

Objective:

The Task Force recommends a budgeting process that will improve the way South Carolina funds government agencies and programs in order to focus on results. South Carolina has generally practiced an incrementalist approach to funding. Incremental Funding emphasizes decisions made on prior years' budgets; therefore, limiting an agency's abilities for long term planning. An improved budgeting process will strengthen agency accountability for taxpayer investment in state government and will clarify the outcomes gained through management of the budget process. Change required: statutory and administrative.

Background:

The economy began slipping into a recession in late 2000. By law, the State must produce a balanced budget each year. The state revenue is based on projections, which are set and closely monitored by the BEA. If the projections fall short of the actual growth, the BEA informs the Governor, General Assembly, and the Budget and Control Board. Reductions in the state budget may be across the board, when issued by the Budget and Control Board, which affects all agencies, or as in the Appropriation process, may affect individual agencies. The following is an overview of the across the board budget cuts that have occurred over the last 3 years:

FY	% Reduction	Date	Total Cut
FY 2000-01	1 percent	May, 2001	$48 million
FY 2001-02	4 percent	October, 2001	$204 million
FY 2001-02	2.5 percent	March, 2002	$121 million
FY 2002-03	5 percent	December, 2002	$246 million
TOTAL CUTS TO AGENCIES			**$621,163,457**

Another across the board budget cut can be expected this year unless the economy grows by 6 percent in the last quarter of 2002. Agencies suffered other reductions during the state budget process, varying by agency. However, to gain a general overview the following are examples of budget reductions from FY 2000-01 to FY 2002-03:

Agency Grouping	% Change
Human Service Agencies	-6.20
Higher Education Institutions & Agency	-8.76
Corrections & Public Safety Agencies	-17.34
Natural Resource Agencies	-21.99

During the first round of budget reductions, agencies examined operational budgets for cuts, imposed hiring freezes, and offered retirement incentives to reduce costs. The most expensive line item for state agencies is personnel and fringe benefits funding. Therefore, as agencies receive larger cuts from year to year, many agencies began imposing Reduction in Force Policies to eliminate staff positions.

However, the House and Senate continue to fund recurring state costs in various state agencies with non-recurring funding which precipitate a further budget crisis. Non-recurring funds are created when the actual revenue received during a year exceeds the estimated revenue used when preparing the state budget. However, many agencies depend on these funds for standard operational and/or program costs. As non-recurring funds diminish, the budget impact on agencies receiving these funds for recurring programs amplifies. The practice of funding recurring costs with non-recurring funds, commonly referred to as annualizations, has become common over the past several years. The current estimate is that the state must fund an additional $300 million with recurring funds to capture the total cost of state government. Over $212 million of non-recurring funds were designated in the FY 2002-03 budget cycle.

The Task Force recognizes that performance-based program budgeting focuses on program awareness, accountability, and results. Through meetings, research, and communication with government officials with experience in the area, we are recommending the agency accountability process should incorporate Performance Based and Zero-Based Budgeting principles.

By utilizing **performance-based budgeting (PBB)**, agency budget requests can include the funding that agencies would like to receive. It also can include specific services to be rendered and its anticipated results. Agencies report their actual performance in their strategic or long-range program plans and budget requests for the fiscal year. Agencies may be given incentives for performance that exceeds standards or disincentives for performance that falls below standards. These incentives and disincentives can be monetary or not. A non-monetary incentive would be an increase in budget flexibility for greater efficiency and effectiveness. A performance bonus for an employee and manager agency-wide or units within the agency that exceed standards is one example of a monetary incentive (*www.oppaga.state.fl.us/budget/pb2.html*).

Using **zero-based budgeting (ZBB)** requires agencies to justify entire base appropriation, including new or modified programs. Agencies begin at "point zero" and advocate for their full slate of programs and their accompanying funding requirements. ZBB stresses that no presumptions or preconceived notions exist. Agencies must ask three critical questions:

- What if a program is discontinued?
- What if a program is cut back?
- What if a program is enhanced?

This highly involved budgetary justification process is done for every budget cycle (*Perspectives on Public Budgeting*, Young 38).

In addition, ZBB also requires agencies to

- focus on a comprehensive analysis of objectives and needs in the budget process
- combine planning and budgeting into a single process
- cause managers to evaluate in detail the cost effectiveness of their operations
- expand management participation in planning and budgeting at all levels of the organization.

Recommendation:

The Task Force recognizes that performance-based and zero-based budgeting is needed to focus attention on program awareness, accountability, and results. Key components of a successful program include:

1) **Leadership**- This needs to be brought into a long-term view of how this could practically be implemented and the opportunity for better and more efficient service delivery. Goal setting and performance standards will permeate throughout each agency, affecting employees at all levels with incentives or corrective measures.

2) **Vision**-Within the next 6 years if implemented properly, state functions would be broken down into five areas to better coordinate and measure service impact to the citizenry:

    a. **Business Relationships** - agencies that regulate, register, collect information and/ or dollars from business entities, such as DOR, Insurance, LLR, and DHEC

    b. **Family-** agencies that work with parents and children's health, education and welfare need, such as DOE, Mental Health, and DSS

    c. **Criminal Justice** - law enforcement agencies, such as SLED, Probation, Pardon and Parole, and DPS

    d. **Land-** agencies such as PRT, DOT, and Natural Resources

    e. **Operational Agencies-** those agencies necessary to run government, such as BCB

3) **Implementation**- Identify volunteer agencies to serve as pilot projects. Volunteer agencies have experience in performance measures and understand key measures and have working relationships with the agencies with which they should be coordinating.

4) **Contract Consultant**- Consulting firms such as Deloitte and Touché, KPMG are experienced in implementing the process; understand how to cross-matrix the functions, and how to identify the key measures.

5) **Legislation**- Must be supported by statewide phase in implementation, including requiring long range strategic planning, develop a process to sunset agencies which are outside the Governor's cabinet. Early legislative involvement is needed.

6) **Technology**- This is a key component to integrating services and measuring results. (The Task Force also suggests consolidation and standardization of technology).

With the current budget crisis, South Carolina should move toward performance-based budgeting with zero-based budgeting principles.

See Attachment 1 - *Current South Carolina Accountability and Budgeting Process*
See Attachment 2 - *The Recommended Florida Model*
See Attachment 3 - *Suggested Administrative and Legislative recommendations*

SPENDING LIMITATION

Objective:

The Task Force recommends enacting a binding spending limitation on state appropriations that provides a more stable and predictable funding stream for state government. Change required: statutory and Constitutional.

Background:

According to South Carolina law, appropriations cannot exceed the spending limit, determined by the greater of average growth of personal income over the last 3 years or 9.5 percent of total personal income. The greater of these two has historically been the second. In FY 2000-2001, this spending limit resulted in a capacity of about $1.5 billion. As is evident, the current spending limit is not a binding constraint. Historically, the "annual spending limit has exceeded the average annual total appropriations by 16 percent" (Barr, *An Overall Evaluation of Formulas* 2000). In fact, South Carolina's spending constraint is so far from being a real constraint as to be referred to in national reports as how a spending limit does not work (Stansel, *Are Tax and Spending Limits the Answer?* 1994).

The State of South Carolina's present model of forecasting for budget purposes requires the BEA to provide a final estimate of state revenues by February for the fiscal year that begins the following July. Projecting a state's economy is difficult but translating that forecast into how much and when state revenues will be received is extremely difficult. The question becomes not if the state is going to be wrong in their revenue forecast, but by how much the estimate will be erroneous. And this problem is not unique to South Carolina.

In order to provide a more stable and predicable funding of state budget expenditures, the state needs to establish a real and binding state spending limitation. This spending rule would on the prior year's expenditures and then add a growth factor. Strong consensus in the Task Force and under consideration outside the Task Force is that the growth factor be based not on personal income growth but on growth in population and the Consumer Price Index (CPI). The Task Force did not achieve consensus as to if an extra one percent should be added to CPI and population growth to accommodate growth in spending (the idea being that using only CPI and population growth may be too restrictive). A real opportunity exists for more than revenue stabilization, but for a real reduction in spending by state government. This is probably only possible with the discipline of a truly rigorous spending limit.

If the spending limit is strict enough to realize real limitation, then at some point in the future some debate may arise over the degree to which statutory and formula driven spending demands outstrip the spending limitation. That is a possible point for concern if the limit is so low that the inflation driven education and health budget demands (historically inflating at higher sector rates than a national average) would exceed the limits.

Much of the current discussion refers to Colorado's formula where voters approved a formula capping spending increases at the rate of inflation plus population growth, or at 6 percent, whichever is lower. The Task Force did not discuss setting a maximum percentage (essentially capping the cap in case inflation grows substantially).

Barr's research shows that most sectors of state appropriations, including health and education, are predicated on growth factors closer to population and CPI. This implies an overall reliance on a method based on population and CPI seems reasonable.

The Task Force expects that a spending limitation plan will be recommended by the House Ad Hoc Tax Study Committee. This committee studied tax and spending issues in the Summer/Fall of 2002, focusing on the need for stricter spending limits based on population growth and the CPI with allowance to assist in recovery from any Presidentially declared disaster.

Time constraints did not permit an economic modeling or testing of this limit. The Task Force recommends that an independent economic study be conducted that specifically examines this recommendation regarding population, CPI over the past ten years of budgets, and the degree to which the limitation involves education and health care cost drivers. This study should also be undertaken by the state economist to advise the Governor and the General Assembly. Research indicates that if this rule would have been in place in 1994 (at the beginning of the state's spending / revenue expansion) the state could have avoided some cuts that it has experienced (in that programs would not have been awarded funding that has subsequently been taken away). Such a plan would avoid annualizations; allow monies to be channeled into a rainy day fund and to replace what has been taken from that fund to date; allow state government to grow at a more predictable rate; provide stability to taxpayers and agencies and allow government to set priorities for increases in state surplus (capital budgets were discussed). The Task Force believes that the limit should immediately be set.

Those revenues that exceed the limit would be restricted to spending on "one-time" uses only (capital projects are most often cited as a reasonable expenditure). In addition, any nonrecurring funds realized over the spending limitation should first be dedicated to complying with existing state law that requires that reserve funds be replenished first. Funds below the spending limit would be allowed to be spent on recurring and on-going expenditures, whereas those above would be restricted to one-time use.

The consensus based on testimony and research is that the limit should apply to spending and not revenues. As Stansel of the Cato Institute notes:

> . . . limiting spending growth to the growth rate of personal income would have resulted in a slower rate of state spending growth over the last decade than occurred (30 percent compared to 42 percent). However, a TEL [spending limit method] limiting the growth of state spending to the growth rate of population plus inflation would have provided a far stricter limit on real state spending growth, holding it to only 10 percent from 1980 to 1990, less than one-fourth the 42 percent rate at which it actually grew and one-third the rate at which a personal income-linked TEL would have allowed spending to grow. Thus, TELs limiting spending growth to the growth rate of population plus inflation are far preferable if the goal is to tame spending.
> . . . the evidence suggests that linking spending to population growth plus inflation is much more restrictive. To illustrate the different effects of those two types of limits--personal income linked versus population linked—[examined the record of the 80s]. Throughout most of the 1980s the economy was booming, thus personal income rose at abnormally high rates, 30 percent in real terms from 1980 to 1990. In those prosperous times, government revenues were pouring in, allowing spending to skyrocket as well. Real state spending shot up by 42 percent from 1980 to 1990. Meanwhile, the U.S. population grew at only a modest rate of 10 percent. (*Are Tax and Spending Limits the Answer?* 1994).

Research indicates that other options are available. Some states require supermajorities in their legislatures to approve tax increases and some cannot raise taxes without a referendum. Over half of the states have adopted some kind of limit on either spending or taxes. Also, it should be required that we not let nonrecurring spending drive recurring spending. If we approve the purchase of a vehicle or a building then we must acknowledge that it costs recurring dollars to operate that vehicle or building. We should require a certificate that states that if recurring funds are to be used to support a nonrecurring purchase that those funds are available in an agency budget to support that use or if not that the General Assembly must provide for those funds. Other areas for possible consideration to this discussion are protections for the spending limit, such as requiring voter approval for its provisions to be avoided and application to both state and local governments.

Recommendation:

The Task Force recommends enacting a realistic binding spending limitation on state appropriations that provides a more stable and predictable funding stream for state government. The spending rule would be based upon the prior year expenditures and then add a growth factor. The growth factor would be based not on personal income growth but on growth in population and the CPI.

A real opportunity exists for more than revenue stabilization, namely the containment of the growth of state government. This could be possible with the discipline of a truly rigorous spending limit. The Task Force considers that limiting spending growth to CPI and population growth is rigorous given the likelihood of challenging growth rates in costs for healthcare and education and the likelihood that the federal government may continue to push more responsibility to the state.

ANNUALIZATIONS

Objective:

The Task Force recommends that the state discontinue the practice of budgeting recurring costs with non-recurring funds. Change required: statutory.

Background:

In prior years, the practice of using non-recurring funds for recurring programs has created a financial mismatch. These are referred to as annualizations. The expenditure of one-time funds is not in itself an unhealthy practice. As long as one-time funds are spent on non-recurring items, they do not directly lead to future obligations – and thus are not disruptive. While annualizations have long been a practice in state budgeting, it dramatically increased in the 1990s. A vibrant and growing economy, however, minimized its negative impact. In FY 2000, however, the economic slowdown revealed the depths of the problem. The growing reliance on annualizations – which culminated in more than $500 million in FY 2000-2001 – combined with the weakening economy, deflated the budget. Since, the dependence on annualizations has been reduced from approximately $500 million to approximately $250 million for the FY ’03-’04 budget.

Recommendation:

The Task Force recommends that the State develop a process for monitoring and controlling the matching of recurring and non-recurring revenues and expenditures, including the following:

- Develop a clear definition of what constitutes annualizations, both in terms of programs and revenues. Require that budget documents clearly indicate which funds (recurring or non-recurring) are to be applied to annualizations.

- There should be a prohibition that only recurring funds can be used for on-going programs and that surplus, one-time funds can only be used for capital or one-time projects. The Task Force suggests a clear identification and linkage from the revenue process to the expenditure process that clearly delineates what funds are spent where. In addition to this identification or certification during the budget process that recurring revenue matches recurring expenditures and that non-recurring revenues match non-recurring expenditures, there also needs to be a general overall certification that the budget is in balance. This should occur at each major step in the budget process, including the Governor's version, the House version, and the Senate version and at conference committee levels. The committee further recommends that an official body independent of the Legislative Branch make the certification.

The Task Force also recommends that the Capital Reserve Fund (CRF) code section be tightened. The CRF should only be used for strictly, specific non-recurring purposes. The Task Force recommends that the phrase "or other nonrecurring purposes" found in Section 11-11-320 (C) (c) be deleted. In addition, expenditures in case of disaster should be added to the list of specific items.

CAPITAL BUDGETING

Objective:

The Task Force recommends a more formal process of capital planning and budgeting. This process should result in a more systematic allocation of resources to meet the maximum level of capital needs for the funds available over specific time periods. This can be accomplished through a Capital Planning and Budget Authority. Change required: statutory.

Background:

The State's Capital Improvement Program has gone through three major modifications, in Fiscal Years 1958-59, 1975-76, and 1986-87. In each case, the changes made were intended to reduce and manage the growing state debt burden. In 1975, the 5 percent debt service limit was enacted into law and placed in the Constitution in 1977. In FY 86-87, the Budget and Control Board and the Joint Bond Review Committee were given the responsibility for regulating the start dates of capital improvement projects authorizing capital improvement bond funds, so that the debt service would remain under the 5 percent limit. At the present time, the state debt service is again approaching the limit.

This proposal is not focused on the debt limit issue, but on improving the state's overall capital improvement program.

South Carolina has a limited amount of capital resources and considerable capital needs. The State's current capital planning processes are ineffective because a comprehensive capital planning policy is not in place to provide a framework for optimal allocation of limited resources. Capital planning policy is delegated to the individual agencies and institutions that request funding based on agency internal planning without the benefit of a statewide capital needs analysis. These problems have become manifested in the following ways:

- Lack of a long-term capital needs assessment and planning document
- Lack of estimates of capital funds available during a multi-year time period to address the identified needs
- Lack of coordination between the operating budget and capital appropriations/budgets
- Lack of statewide standards and priorities for capital budgets
- A proliferation of partially funded capital projects
- An increasing amount of deferred maintenance that is not being addressed
- Estimates of project costs that are often not realistic
- Ongoing operational costs of capital projects are not being properly funded
- Failure to utilize the Capital Reserve Fund for its intended purpose—which would decrease the volume of capital improvement (general obligation) bonds outstanding over time.

South Carolina should implement a more formalized process of capital planning and budgeting. This process should result in a more systematic allocation of scarce resources to meet the maximum level of capital needs for the funds available over specific time periods. This can be accomplished through a Capital Planning and Budget Authority.

The Task Force recommendation is to expand the membership and authority of the Joint Bond Review Committee (JBRC) to become a Capital Planning and Budget Authority. The Authority would consist of the five members of the State House of Representatives and the five members of the State Senate that currently comprise the membership of JBRC. In addition, the Governor, the State Treasurer, the Comptroller General, and two public/private members to be appointed by the Governor would be added to the ten legislative members for a total of 15.

The Authority's powers and duties would include, but not be limited to, those currently provided for and given to the Joint Bond Review Committee. In addition, the Authority would be given responsibility for long-term capital planning policy, setting statewide standards and priorities for capital projects, and responsible stewardship of the State's capital assets.

These responsibilities might result in some or all of the following:

- An annual capital budget being a separate section and part of the State's annual operating budget (as a Part II)
- All capital projects would be identified in the capital budget and all funding sources would be included
- The current CPIP (Comprehensive Permanent Improvement Plan) planning processes would be simplified and integrated into one long-term planning process, which includes project priorities identified by the Authority using objective standards
- Projects not identified in the long-term planning process would not be eligible for state funding, except in exceptional circumstances
- Mandatory uniform reporting of a facilities condition index on buildings, as part of the long-term planning process, would be used to address maintenance and funding needs for existing facilities.

The existing part-time staff of the Joint Bond Review Committee should continue to serve as staff for the Authority. In addition, the staff of the Capital Improvements Unit of the Budget and Control Board's Office of General Services should provide the staff work for the Authority, much as it does for the Joint Bond Review Committee now.

Recommendation:

The Task Force recommends that a Capital Budgeting Authority be created, which will be the origination point for all state buildings and bond requests. This allows for a quantitative evaluation of each project and statewide priorities of needs. This Joint Authority should include the Governor, the State Treasurer, the Comptroller General and two public/private members appointed by the Governor.

BIENNIAL BUDGETING

To encourage long-term planning and to reduce the costs of producing an annual budget, some states develop a two-year budget, referred to as biennial budgeting.

Recommendation:

The Task Force does not recommend that the state move to a two-year budget cycle this year. The Task Force found that, although it does result in agencies planning in longer terms, there is no appreciable cost savings to be received in the short term. Also, given the significant recommendations the Task Force is proposing in the budget process, time could be best served by establishing a better annual system of budgeting before pursuing a biennial budget process in the future.

GUBERNATORIAL VETOES

In the decision delivered by the South Carolina State Supreme Court on April 18, 2002 for the case Condon v. Hodges (Opinion No. 25451), the Court stated that "the Governor is not required to return a balanced budget to the General Assembly." Contained in the Fiscal Year 2001-02 General Appropriations bill were negative appropriation lines representing base budget cuts for most state agencies. The Governor vetoed selective negative lines and affected a transfer of funds in order to insure that expenditures did not exceed anticipated revenues. As a part of the ruling, the Supreme Court found that the transfers were illegal thus making the appropriations bill out of balance. Nevertheless, the Governor did not have placed upon him the same burden as the General Assembly to produce a balanced budget as he considered budget vetoes.

Recommendation:

The Task Force recommends a constitutional prohibition should be enacted so that the exercise of a gubernatorial budget veto does not cause appropriations to exceed projected revenues.

Section 1.01 *Attachment 1*

(a) Current South Carolina Accountability and Budgeting Process:

Accountability Process:

Each year South Carolina state agencies are required under statute to submit an Accountability report to the Office of State Budget no later than Friday, September 13, 2002. Guidelines are developed in consultation with staff from the Governor's Office, Senate Finance Committee, and the House Ways and Means Committee.

The Governor and the General Assembly intend the Accountability Report as a concise, straightforward report on performance for review. The report gives the "big picture" and is viewed as a "snapshot" of the agency's progress toward fulfilling its mission. The guidelines are modeled heavily on the reporting requirements for Malcolm Baldrige National Quality Award criteria. The 7 Elements of Malcolm Baldrige Award Criteria are:

- Leadership
- Strategic planning
- Customer focus
- Information and analysis
- Human resources
- Process management
- Results

The guidelines lay out a series of questions for reporting. Agencies are encouraged to continually review their performance measures, seek improvement, and report on the results of measures and trends over time using appropriate benchmarks.

It is not expected that detailed information be reported but rather should be retained at the agency level should more detail be desired by the Governor or General Assembly. Each section of the report is intended to encourage agencies to report only the key indicators of performance.

Sections 1-1-810 and 1-1-820 of the 1976 Code of Laws state:

> Section 1-1-810. Each agency and department of state government shall submit an annual accountability report to the Governor and the General Assembly covering a period from July first to June thirtieth, unless otherwise directed by the specific statute governing the department or institution.
>
> Section 1-1-820. The annual accountability report required by Section 1-1-810 must contain the agency or department's mission, objectives to accomplish the mission, and performance measures that show the degrees to which objectives are being met.

In addition, the FY 2002-2003 Appropriation Bill as currently drafted provides that:

> Agencies' annual accountability reports for the prior fiscal year, as required in Section 1-1-810, must be accessible to the Governor, Senate Finance Committee, House Ways & Means Committee and to the public on or before September 15, for the purpose of a *zero base budget analysis* and in order to ensure that the Agency Head Salary Commission has the accountability reports for use in a timely manner. Until *performance based funding* is fully implemented and reported annually, the state supported colleges, universities and technical schools shall report in accordance with Section 59-101-350.

Budgeting Process:

The budgetary process begins each year in September with the submission of a Budget Request to the State Budget Office. The timeline for submission is around late October. The Budget Request is the beginning of a fiscal management system that culminates in the Appropriation Act finalized in June of the following year.

The Budget Request Plan that covers the upcoming fiscal year is a comprehensive tool that is used to identify needs within an agency for both operations and capital. Operational requests, such as additional dollars or FTEs, require justification. Capital requests follow the Comprehensive Permanent Improvement Plan (CPIP) and require justification. The Budget Request Plan also includes changes, additions, or deletions to provisos. These also require justification for action. The Budget Request Plan is submitted to the State Budget Office in the fall of each year. The Budget Office provides this information to House Ways and Means, Senate Finance, and Governor's Office.

During the fall, the Detail Budget outlines the current fiscal year and is submitted to the State Budget Office. The Detail Budget document is the basis for the Appropriation Bill debated by the Legislature and must be completed in a timely manner for distribution to the members of the General Assembly. It is the responsibility of each agency to submit its Detail Budget in the format and the manner prescribed by the State Budget Office in order to meet the publication deadline. The Detail Budget is the beginning of the legislative process. It is a cumulative look at past, present, and future budget years. Details are outlined by program for expenditures, revenues, and FTEs. All details must be in balance between revenue and expenditures. This is a critical first step to the Appropriation Act, the means to the end. Agency chief financial officers are tasked with this responsibility and must work very closely with the State Budget Office for it to be accomplished.

Once these two integral components of the budget process are complete, the legislative process begins. The legislative process for all agencies begins in the House of Representatives, with the House Ways and Means Committee. Each agency is assigned to a subcommittee under the Ways and Means Committee. Agencies report before their subcommittee on their Accountability Report and Budget Request Plan. Each subcommittee will then report to the Ways and Means Committee. Agencies may be asked to report before the full Ways and Means Committee as well. The Ways and Means Committee then submits their information back to the State Budget Office for balancing and printing before going to the House of Representatives for full debate. Once full House debate and passage of the Appropriations Bill is complete, the State Budget Office must again balance and print the Bill to be sent to the Senate Finance Committee. A similar scenario takes place in the Senate beginning with the subcommittees of Senate Finance and proceeding through to full Senate debate and passage. At this time, there are two similar bills that are balanced to the estimates of revenue – one from the House of Representatives and the other from the Senate. A Conference Committee then convenes to complete the task of bringing the two bills together as one and in balance. The Conference Committee is comprised of three members from each legislative body. Once this is complete, the State Budget Office balances and prints the Appropriations Act for passage by the House of Representatives and the Senate. Once passage occurs, the Appropriations Act is sent to the Governor for signature and/or veto.

While the Agency Accountability Report process and the Budget process run concurrently during the fall of each year, the legislation creating these two processes did not create the mechanism for the integration of accountability and fiscal management. The criteria for such integration is outlined in the performance management and zero based budgeting sections of the Agency Accountability Report legislation and guidelines. The accountability report approach has yet to be incorporated into the budget request and analysis process taken by the Budget Office in mid to late October. Agencies outline their fiscal measurements in the agency's accountability report but these measures may or may not be included in the budget request and budget detail documents submitted to the Budget Office in the fall of each year.

Section 1.02 *Attachment 2*

(a) The Recommended Florida Model:

This subcommittee reviewed several states' performance and accountability programs including Florida, Texas and Virginia. The committee discovered that Florida state government is recognized as a leader in performance-based program budgeting and is ahead of other states and the federal government in funding programs based on results. *The subcommittee conducted a conference call with Dr. Jim Zingale, Executive Director of Florida Department of Revenue and authority on Florida's Performance-Based Budgeting Program.*

Florida has one of the most fully developed systems of performance reporting and budgeting of any state. The Florida program sets performance expectations in conjunction with funding for each agency program using zero based budgeting principles and strategic and long-range planning (each agency is required to have a 3-year business plan). Originally called Performance-Based Program Budgeting (abbreviated as PB^2) when agencies were phased into this type of budgeting, now all agencies are funded this way as a matter of course.

Florida's performance-based program budgeting (PB^2) experience shows that focusing on performance and strategic planning have improved accountability for state programs, led to better public services, and produced cost savings.

Under Florida statute, (PB^2) was phased in for state government over a seven-year period. An average of five agencies were designated to the (PB^2) process every year until fiscal year 2001-2002. When required by the statutory schedule, each agency must provide the Executive Office of the Governor with a list of programs that it believes are conducive to performance-based budgeting. The following year, the agency submits performance measures for each of these programs. These measures are to assess program outputs (products produced by the agency), unit costs measures (direct cost of producing one unit of output) and outcomes (program results). The agency must also submit baseline data showing its past and current performance and proposed standards for performance on each measure for the coming year.

The Governor may approve, modify, or reject the programs, measures, and performance standards. Approved programs and measures are then included in the agencies' Legislative Budget Requests.

Under Florida statue each state agency shall be subject to a program evaluation and justification review by the legislature. The review shall be conducted on major programs, but may include other programs. The review shall be comprehensive in its scope but, at a minimum, must be conducted in such a manner as to specifically determine the following, and to consider and determine what changes, if any, are needed with respect thereto:

(a) The identifiable cost of each program;

(b) The specific purpose of each program, as well as the specific public benefit derived there from;

(c) Progress toward achieving the outputs and outcomes associated with each program;

(d) An explanation of circumstances contributing to the state agency's ability to achieve, not achieve, or exceed its projected outputs and outcomes, as associated with each program;

(e) Alternate courses of action that would result in administration of the same program in a more efficient or effective manner. The courses of action to be considered must include, but are not limited to:

1. Whether the program could be organized in a more efficient and effective manner, whether the program's mission, goals, or objectives should be redefined, or, when the state agency cannot demonstrate that its efforts have had a positive effect, whether the program should be reduced in size or eliminated.

2. Whether the program could be administered more efficiently or effectively to avoid duplication of activities and ensure that activities are adequately coordinated.

3. Whether the program could be performed more efficiently or more effectively by another unit of government or a private entity, or whether a program performed by a private entity could be performed more efficiently and effectively by a state agency.

4. When compared to costs, whether effectiveness warrants elimination of the program or, if the program serves a limited interest, whether it should be redesigned to require users to finance program costs.

5. Whether the cost to administer the program exceeds license and other fee revenues paid by those being regulated.

6. Whether other changes could improve the efficiency and effectiveness of the program.

(f) The consequences of discontinuing such program. If any discontinuation is recommended, such recommendation must be accompanied by a description of alternatives to implement such recommendation, including an implementation schedule for discontinuation and recommended procedures for assisting state agency employees affected by the discontinuation.

(g) Determination as to public policy, which may include recommendations as to whether it would be sound public policy to continue or discontinue funding the program, either in whole or in part, in the existing manner.

(h) Whether the information reported as part of the state's performance-based program budgeting system has relevance and utility for the evaluation of each program.

(i) Whether state agency management has established control systems sufficient to ensure that performance data are maintained and supported by state agency records and accurately presented in state agency performance reports.

(j) No later than December 1 of the second year following the year in which an agency begins operating under a performance-based program budget, the Office of Program Policy Analysis and Government Accountability(for SC Budget And Control Board State Budget Office) shall submit a report of evaluation and justification review findings and recommendations to the President of the Senate, the Speaker of the House of Representatives, the chairpersons of the appropriate substantive committees, the chairpersons of the appropriations committees, the Legislative Auditing Committee, the Governor, the head of each state agency that was the subject of the evaluation and justification review, and the head of any state agency that is substantially affected by the findings and recommendations.

(k) The Legislature intends that the program evaluation and justification review procedure be designed to assess the efficiency, effectiveness, and long-term implications of current or alternative state policies, and that the procedure results in recommendations for the improvement of such policies and state government. All reports submitted must include an identification of the estimated financial consequences, including any potential savings, that could be realized if the recommendations or alternative courses of action were implemented.

(l) Evaluation and justification reviews may include consideration of programs provided by other agencies that are integrally related to the programs administered by the state agency or entity which is scheduled for review.

The Legislature considers the information provided and may reject, modify, or approve the programs, measures, and standards offered. In the General Appropriations Act, the Legislature then designates acceptable agency programs, performance measures, performance standards, and the resources appropriated to accomplish these standards.

Agencies under performance-based program budgeting have been provided a lump-sum appropriation for each of their programs, which provides managers with flexibility in using the funds (funds can transferred from one expenditure category to another). As part of the subsequent year's appropriations process, the Legislature will examine actual performance of these programs in comparison to their standards. The Legislature may provide incentives (such as more budget flexibility) to agencies whose programs meet their performance standards. It may also impose disincentives (such as budget reductions) if agency programs fail to meet their performance standards.

Carter, Karen. *The Performance Budget Revisited A Report on State Budget Reform*. Legislative Finance Paper #91,

National Conference of State Legislatures, Washington, DC, February 1991.

2 Chapter 94-249, Laws of Florida. Report No. 9677A

Section 1.03 *Attachment 3*

(a) Suggested Administrative and Legislative recommendations:

Suggested Administrative Processes:

- **State Agencies-** Agencies are responsible for administering programs funded under the performance-based system. Agency staff also monitors performance and report progress towards achieving program goals annually. Each year the agency submits a legislative budget request that includes specific performance measures and performance standards that correspond to the agency's 3-year business plan. Agency heads and agency auditors are responsible for assessing the reliability and validity of performance data included in the budget request and for recommending improvements.

- **The Executive Office of the Governor-** The Office Executive of Planning and Budgeting (OEPB) within the Executive Office of the Governor is responsible for state planning and budgeting. This office reviews agency requests for funding and prepares the Governor's Budget Recommendations to submit to the Legislature. These recommendations contain the proposed programs, measures, and standards the Governor's Office recommends in the proposed budget.

- **The South Carolina Legislature-** The Legislature has final approval of agency programs, performance measures, and performance standards. Programs, measures, and standards are incorporated in the state's budget, referred to as the Appropriations Act, or an implementing bill to that act. The act also specifies the amount of funding and number of authorized staff positions for each agency program. Typically, substantive legislative committees approve proposed programs and measures, while appropriations committees approve funding levels and performance standards. The budget is passed each year by the Legislature and is signed into law by the Governor. The budget is in effect for one year, beginning July 1 and ending June 30 of the following year.

- **Budget and Control Board Office of State Budget-** State Budget Office consults with agencies developing proposed performance programs, performance measures and standards, advises the Governor's Office and Legislature about proposed performance programs, measures, and standards, and conducts program evaluation and justification reviews.

Suggested Legislative Processes:

1. Each state agency shall be subject to a program evaluation and justification review by the South Carolina Budget and Control Board Office of State Budget. Each state agency shall offer its complete cooperation to the Office of State Budget so that such review may be accomplished.

2. The agency head or person designated shall develop, in consultation with the Office of State Budget, a plan for monitoring and reviewing the state agency's major programs to ensure that performance data are maintained and supported by agency records.

3. The program evaluation and justification review shall be conducted on major programs, but may include other programs. The review shall be comprehensive in its scope but, at a minimum, must be conducted in such a manner as to specifically determine the following, and to consider and determine what changes, if any, are needed with respect thereto:

   a) The identifiable cost of each program.

   b) The specific purpose of each program, as well as the specific public benefit derived therefrom.

   c) Progress toward achieving the outputs and outcomes associated with each program.

   d) An explanation of circumstances contributing to the state agency's ability to achieve, not achieve, or exceed its projected outputs and outcomes associated with each program.

   e) Alternate courses of action that would result in administration of the same program in a more efficient or effective manner. The courses of action to be considered must include, but are not limited to:

      (i) Whether the program could be organized in a more efficient and effective manner, whether the program's mission, goals, or objectives should be redefined, or, when the state agency cannot demonstrate that its efforts have had a positive effect, whether the program should be reduced in size or eliminated.

      (ii) Whether the program could be administered more efficiently or effectively to avoid duplication of activities and ensure that activities are adequately coordinated.

      (iii) Whether the program could be performed more efficiently or more effectively by another unit of government or a private entity, or whether a program performed by a private entity could be performed more efficiently and effectively by a state agency.

      (iv) When compared to costs, whether effectiveness warrants elimination of the program or, if the program serves a limited interest, whether it should be redesigned to require users to finance program costs.

      (v) Whether the cost to administer the program exceeds license and other fee revenues paid by those being regulated.

      (vi) Whether other changes could improve the efficiency and effectiveness of the program.

   f) The consequences of discontinuing such program. If any discontinuation is recommended, such recommendation must be accompanied by a description of alternatives to implement such recommendation, including an implementation schedule for discontinuation and recommended procedures for assisting state agency employees affected by the discontinuation.

   g) Determination as to public policy, which may include recommendations as to whether it would be sound public policy to continue or discontinue funding the program, either in whole or in part, in the existing manner.

h) Whether the information reported as part of the state's performance-based program budgeting system has relevance and utility for the evaluation of each program.

i) Whether state agency management has established control systems sufficient to ensure that performance data are maintained and supported by state agency records and accurately presented in state agency performance reports.

4. No later than December 1 of the second year following the year in which an agency begins operating under a performance-based program budget, the Budget and Control Board Office of State Budget shall submit a report of evaluation and justification review findings and recommendations to the President of the Senate, the Speaker of the House of Representatives, the chairpersons of the appropriate substantive committees, the chairpersons of the appropriations committees, the Governor, the head of each state agency that was the subject of the evaluation and justification review, and the head of any state agency that is substantially affected by the findings and recommendations.

5. The Legislature intends that the program evaluation and justification review procedure be designed to assess the efficiency, effectiveness, and long-term implications of current or alternative state policies, and that the procedure results in recommendations for the improvement of such policies and state government. To that end, whenever possible, all reports submitted pursuant to subsection (4) must include an identification of the estimated financial consequences, including any potential savings that could be realized if the recommendations or alternative courses of action were implemented.

6. Evaluation and justification reviews may include consideration of programs provided by other agencies which are integrally related to the programs administered by the state agency or entity which is scheduled for review as determined by the Office Executive of Planning and Budgeting and/or the Budget and Control Board Office of State Budget.

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